

- (ii) The "productivity factor" in the rate adjustment formula should reflect the high productivity levels achieved and achievable by LECs in an industry and era characterized by rapidly developing technology.

The calculation of an historical productivity factor based on actual LEC data for the post-divestiture era is a critical component in the determination of an appropriate X factor. In general, capital intensive industries, such as telecommunications offer potential for greater than average productivity gains when compared to labor intensive industries such as health care and education. In telecommunications, advances such as digital switching, fiber optic transport, and advanced signalling technologies, have provided LECs with enormous opportunities for productivity enhancements, translating into cost reductions which can, and should, be passed on to business and residential customers -- reductions which would be passed on under competitive market conditions. With expected further price reductions and increased capabilities associated with telecommunications system components such as semiconductors, computers, switches, software and other capital goods, the technology-driven productivity enhancement trend in telecommunications should continue. However, by accepting the assumption that LEC input prices are growing faster than the general output price inflation rate represented by the GNP-PI, the existing price caps productivity offset ignores these important productivity gains. Accordingly, a correct representation of LEC output price changes must combine the

historic productivity growth rate achieved by the LECs with the productivity gains reflected in LEC input prices. With respect to historic productivity growth, the formula should be represented as GNP-PI, minus the input price differential, minus the historic LEC productivity growth rate.^{19/}

The target productivity component of the X factor selected by the Commission is extremely important because if it is set too low (i.e., at a level that consistently understates productivity gains achievable by the LECs), the price cap adjustment mechanism will fail to stimulate a competitive result, allowing LECs to increase prices even where increases in input price levels are less than productivity gains. By comparison, a company operating in a competitive market in such circumstances would be forced to either freeze or reduce its prices. In short, an excessively low X factor will result in excessively high rates for business and residential subscribers.

Available empirical evidence suggests that the average LEC productivity rate is significantly greater than the 3.3% factor now used in the LEC price caps formula. The Commission should recognize this evidence and increase the currently employed unreasonably low X factor.^{20/}

^{19/} Normally, the productivity concept is based on total factor productivity (TFP) which incorporates changes in all inputs (capital, labor and materials) simultaneously.

^{20/} ETI's seven-state study indicates an X factor of at least 5.8%. ETI Analysis, p. 58, fn. 105, and page 59 Table 6.

- (iii) The price cap formula should include a "stretch" factor to account for the effects of price cap program induced economic benefits and to incent LEC efficiency.

Methods using historical productivity studies to determine the productivity factor suffer from the inherent infirmity of being unable to capture the beneficial effects on LEC efficiency and productivity flowing from alternative incentive-based regulation which post-dates the historical data. Moreover, the productivity factor as a general matter should be set so as to encourage improvement in overall LEC efficiency and to recognize the beneficial effects of alternative regulation in stimulating further productivity gains. The stretch component should be applied as a further offset to the GNP-PI inflation index. Combining all three components, the formula would then be represented as the GNP-PI, minus the input price differential, minus the historic LEC productivity growth rate, minus the stretch component.^{21/}

- (iv) Consistently high LEC earnings evidence that prices exceed "competitive result" levels.

Although the price caps regime was intended to allow LECs to retain a substantial portion of profit increases as a reward for bringing about efficiency gains, the fruits of efficiency gains in competitive markets are at best temporary because eventually other firms will emulate the efficient producer or initiate their own efficiencies. Therefore, if price

^{21/} Application of this formula is detailed in the technical discussion presented in the ETI Analysis at pp. 56-65.

caps are intended to "replicate the marketplace forces of competition"^{22/} (i.e., achieve a "competitive result"), it cannot be a goal of price cap regulation that LECs retain achieved levels of profit growth indefinitely. And, since excessive profits are not sustainable over an extended period of time in competitive markets, consistently high LEC earnings levels serve as clear evidence that LEC prices exceed "competitive result" levels. In other words, consistent LEC high earnings levels are a clear indicator that the price cap system is not working as it was (or at least should be) intended.

There is ample evidence that RBHC profit levels grossly exceed reasonable capital attraction needs. One example cited in the ETI Analysis compares new investments made by the RBHCs in their BOC subsidiaries (\$13.5 billion) to their investments in non-BOC subsidiaries both here and abroad (\$21.1 billion) since divestiture.^{23/} In just the three years since LEC price cap regulation took effect, net BOC investment stands at \$564 million while some \$11 billion has been invested in non-BOC ventures. As further discussed in the ETI Analysis, LECs may employ a number of devices to effectively convert excessive profits into other forms of cash flow, and it is not necessarily easy to distinguish whether excessive price increases or improved efficiencies account for a growth in profits. It is therefore critical that the Commission not limit its review of the LEC price cap plan to

^{22/} NPRM at ¶ 12.

^{23/} ETI Analysis, p. 68.

"surface-level" financial reports, but that it delve well below the surface to acquire a full and detailed understanding of how the system is actually working. The Ad Hoc Committee believes that if the Commission does so, it will find that fundamental changes are necessary if price cap regulation is to remain a viable and sustainable approach in the future.

F. Baseline Issue 4: The Sharing And Low-End Adjustment Mechanisms Continue To Be Essential And Should Be Retained, But The Commission Should Re-examine The Relationship Between The "Triggers" And Capital Costs.

The rationale for sharing remains as valid today as it was three years ago when the LEC price cap plan was adopted: it establishes a means by which ratepayers may directly benefit from efficiency gains stimulated by incentive-based regulation; and it serves as a safety net for consumers, reducing the impacts of potential errors in setting the productivity factor and resulting in at least a partial return of any excess monopoly earnings that might be accumulated by the LECs.^{24/} There is also no basis for revising the 50/50 sharing proportion in the basic sharing band, and requiring a 100% return of earnings in excess of the basic sharing range remains the most straightforward and effective means for protecting ratepayers from overearnings extremes.

The Ad Hoc Committee agrees with the Commission's observations concerning the lower interest rate levels now

^{24/} Competition in the provision of interstate access services has not progressed sufficiently to serve as a full effective market-based safety net for consumers.

prevailing,^{25/} and urges a reexamination of the relationship between capital costs and the sharing and low-end adjustment triggers. Because of the absence of effective levels of competition in the provision of interstate access services, LECs have no incentive to flow through their reduced capital costs in the form of reduced prices for their customers. In short, the price cap plan should not permit LECs to retain such capital market induced windfall profits. The benchmark rate of return used for setting the sharing and low-end adjustment triggers should be reset downward.

G. Baseline Issue 6: The Commission Should Narrow And Strictly Define The Scope Of Exogenous Cost Adjustments

The Ad Hoc Committee fully agrees with the Commission's conclusion that it "should reduce the categories of cost changes eligible for exogenous treatment."^{26/} The Committee also supports the Commission's expressed belief that "it would be more consistent with the incentives of a price cap plan to treat only economic cost changes as eligible for exogenous treatment [and that such treatment would] also be more consistent with one of the goals of price caps, to replicate the operation of competition."^{27/} Indeed, in order to more effectively emulate the functioning of a competitive marketplace, the exogenous cost exception must be tightened to exclude all but those economic

^{25/} NPRM at ¶ 54.

^{26/} NPRM at ¶ 64.

^{27/} Id.

changes that are directly attributable to well defined regulatory actions specifically and uniquely affecting LECs. Examples of such changes would be jurisdictional cost shifts and certain other accounting related changes. The Ad Hoc Committee further urges that the key issue in evaluating claims for exogenous cost treatment should not be the magnitude of the impact of the change upon a LEC, but how a cost change of the same type would likely be responded to by nonregulated firms in competitive industries. Such an approach will demonstrate that many "unforeseen cost changes", even where "beyond management control", cannot be automatically passed through to consumers.

The Ad Hoc Committee also shares the Commission's concern that LECs generally initiate requests for exogenous cost changes "and have substantial incentives to report and request exogenous treatment only for those that might generate increases in the cap, not those that might justify reductions."^{28/} This concern is heightened by the fact that exogenous cost changes that would increase LEC costs tend to be readily identifiable, direct in their impact, and relatively large. In contrast, events which would lead to cost decreases are often indirect, far more difficult to identify, and individually small, even though their cumulative effect can be substantial.^{29/}

^{28/} NPRM at ¶ 65.

^{29/} An example of how the resultant upward bias in favor of exogenous cost increases (and against the interests of ratepayers) works in relation to LEC costs for state taxes is discussed in the ETI Analysis at p. 80.

If the price caps regime is to achieve the "competitive result" goal set by the Commission, LECs should have no more protection from unexpected cost increases than firms operating in competitive markets. In competitive markets, businesses face a myriad of conditions that could be described as "exogenous" and "beyond their control" on a daily basis, and are able to survive without the kind of cost protections LECs seek through Z-factor adjustments. Successful firms protect against such contingencies through insurance, reserve funds, effective forecasting and planning, and prudent management. Under the competitive market standard, an appropriate test for exogenous cost treatment should inquire whether a particular type or category of event could have been anticipated and planned for by management, not whether the specific event could have been predicted in advance.

H. Baseline Issue 7A: The Commission Should Continue To Monitor Service Quality and Network Reliability.

The Commission would be well advised to monitor service quality and network reliability without regard to whether it regulates LEC rates pursuant to price caps or a rate base rate-of-return regulatory scheme. Reliable telecommunications has become too important to the nation's economy for the Commission to take a laissez faire approach. Arguably, a price caps regulatory scheme might create a condition in which profit pressures cause carriers to compromise programs which are needed to maintain high service quality and reliability. That condition seems not to have occurred to date. Indeed, the LECs' very

healthy profit pictures suggest that there has not been the kind of pressure which would compromise service quality.

Even though LECs continue to provide high quality service under price caps, the Commission should view service quality monitoring as an early warning system to guard against gradual network degradation. While, the Ad Hoc Committee does not anticipate such gradual degradations, the Commission should not run even a remote risk that failure to monitor service quality could be viewed in the future as akin to the governmental policies which some blame for the savings and loan debacle if service quality does deteriorate, particularly when the cost of a monitoring program is likely to be very low. Completion and periodic submission of service quality forms to the Commission is hardly a crushing burden.

I. Baseline Issue 8a. The Commission's Price Caps New Service Rules Do Not Impede The Development And Introduction of New Services.

The LECs are de facto monopolists, especially with respect to services which are provided over the public switched network. In the absence of effective competition, Commission oversight is necessary to protect consumer interests. The requirement for Commission oversight is articulated in section 201 of the Communications Act of 1934, as amended, which mandates that rates for services subject to the Commission's jurisdiction be just and reasonable. The current requirement that LECs submit adequate cost justification for new services is absolutely necessary to give meaning to the requirements of section 201. The Commission

could not reasonably find that it can rely on the operation of the marketplace to assure that LEC new service rates are just and reasonable. Without cost data, the Commission would be in no position to assess the reasonableness of proposed rates for new LEC services.

LECs cannot reasonably argue that the requirement that rates for new services be cost-based incents them not to offer new services. The Commission's Rules already allow the LECs to attempt to justify new services rates which include risk premiums. These rules give the LECs the same type of incentive that unregulated companies have. Elimination of the cost support requirement would allow the LECs to price gouge their customers. In other words, LECs could earn exploitative returns from some customers if those customers perceived high enough value in the new service offering. This kind of value of service pricing previously has not been and should not now be, sanctioned by the Commission.

J. Baseline Issue 8b: The Price Caps Rules Need To Be Modified To Encourage Innovations And Reasonable Rates.

Implicit in issue 8b of the NPRM is the notion that allowing the LECs to earn higher returns or giving them more flexibility to price new services as they wish without regulatory oversight might be advisable as a means of encouraging new, innovative offerings. Such thinking, however, overlooks the fact that real competition, not exploitative monopoly pricing, is the most likely source of innovation. The ETI Analysis points out that the Commission long ago concluded that monopolists are not likely

to develop specialized applications that enhance efficiency and productivity.^{30/} Monopolists move slowly and develop services and products that are aimed at the mass market. They simply are not good at identifying the niche applications which grow to be more broadly accepted. The Commission again should bet on competition, not monopoly as the best means for encouraging innovation. This is another aspect of the competitive condition that the Commission should strive for through its Price Caps Rules. Indeed, allowing LECs to offer functionalities without sufficient cost support, or to delay submitting cost support, could work against other entities using network based functionalities, such as call control functionalities, to offer new innovative services.

K. Baseline Issue 9a: The Commission Should Not Equalize The Treatment Of LEC And CAP Access Charges For Purposes Of Calculating AT&T's Exogenous Access Costs.

The Commission should not equalize the treatment of LEC and CAP access charges for purposes of calculating AT&T's exogenous access costs because equalized treatment would produce no perceptible benefit for end users and would be inconsistent with the logic that lies behind the Commission's exogenous cost adjustment policy. The ETI Analysis notes that AT&T purchases approximately ninety-nine percent of its access services from LECs, with only about one percent acquired from CAPS^{31/}. Under

^{30/} ETI Analysis, pp. 87-88.

^{31/} ETI Analysis, p. 90.

these conditions, no economic benefit will flow to end users by requiring AT&T to treat as exogenous the access cost savings for Basket 1 services which it might realize as a result of moving access traffic from LECs to CAPs.

Even if CAPs held a much more significant share of the access service market, the Commission should not require exogenous cost treatment of the Basket 1 savings which AT&T would realize from moving access traffic from LECs to CAPS because such savings are the result of precisely the type of cost-cutting behavior that the Commission hoped to incent through price caps regulation. The cost savings are the result of AT&T's initiative, rather than cost savings from regulatory action beyond AT&T's direct control.

L. Baseline Issue 9b: The Commission Should Not Amend Any Other Rules That Relate To LEC Price Caps Regulation To Equalize Treatment Of LECs And CAPs.

It is preposterous to even consider equalizing regulatory treatment of LECs and CAPS. The LECs' overwhelming market dominance and the CAPs' utter lack of market power should end any debate on this subissue.

M. Baseline Issue 10: The Commission Should Not At This Time Revise The Approach That It Uses To Evaluate Petitions For Waiver Of The Price Caps Rules In Connection With Mergers And Acquisitions Of Exchange Properties.

There is some evidence that LECs have learned to maximize the value of exchange properties, perhaps in ways not intended by the Commission when it adopted its high cost exchange support rules. For example, some exchanges may be worth more to a price caps LEC if such exchanges are sold to a smaller LEC which qualifies for high cost exchange support. The Commission should examine this possibility carefully. While the Commission should not modify its price caps rules relative to this subject at this time, it should expeditiously initiate a comprehensive review of its Access Charge and Separations Rules, including high cost exchange support mechanism, and in that process consider whether the price cap rules should be revised to account better for mergers and acquisitions and the sale and swaps of exchange properties.

N. Transitional Issues: The Commission Should Not Make Changes To Its Price Caps Rules Based On A Perception That The Access Service Market Is Effectively Competitive; Such A Perception Would Be Inaccurate.

The NPRM seeks comment on a number of transitional issues, issues which apparently are predicated on the perception that the local exchange and access service markets may be on the verge of becoming effectively competitive. The Ad Hoc Committee believes such perception, assuming such perception exists, to be fundamentally wrong. Niche competition does exist in certain

localities; it, however, is far from pervasive. Indeed, as explained in the ETI Analysis, the competition which today exists is quite limited, and is likely to remain limited for the foreseeable future.^{32/} Therefore, a major overhaul of the price caps rules in contemplation of significant local exchange/access service competition is at least premature.

When, and if, competition becomes sufficiently widespread, the Commission could consider moving individual services out of price caps, rather than tinkering with the service mix in a particular functional basket. If effective competition in a specific service market is not ubiquitous, but is vigorous in more isolated circumstances, the Commission could consider narrowly targeted waiver requests. Proponents of such waivers should be required to demonstrate persuasively that the waiver requests will not produce cross-subsidization or discriminatory effects which would be anti-competitive. They also should be required to prove that the conditions which are the subjects of the waiver requests are narrow and appropriate for waiver.

The LECs' market dominance is also reason for the Commission to continue its triennial review of the performance of its LEC price caps rules. Triennial review is appropriate to assure that the price caps rules are serving the Commission's goals. For example, the ETI Analysis demonstrates that the current productivity factor was too low when it was prescribed over three years ago and will allow, unless increased, the LECs to enjoy

^{32/} ETI Analysis, pp. 90-101.

profit levels and, perhaps more importantly, cash flows which they would not be able to retain in a market that is effectively competitive.^{33/} In an industry marked by declining costs, it would be unreasonable for the Commission to abandon the triennial reviews. End users would suffer by paying excessive rates, and emerging competition would be jeopardized because of the LECs' ability to fund entry into new markets and to meet new competition through the cash flows and earnings which an improperly specified price caps plan would produce.

III. CONCLUSION

The LECs price caps rules need to be revised (through increasing the productivity factor); they should not be virtually abandoned. LECs continue to possess market power. Until the LECs lose their dominant position, the Commission should continue to periodically review its LEC price caps rules so that those rules produce conditions which mimic as close as possible the competitive condition. The Commission should also view its LEC price caps rules as an important tool to use to facilitate the development of competition in the local exchange and access service markets. The Commission would commit an error of profound proportions if through adjustments to the price caps rules it gives the LECs an advantage in building the information infrastructure of the future. LECS should not be allowed to earn more (indeed, quite the opposite), or keep more of what they

^{33/} ETI Analysis, pp. 47-70.

earn. Nor should the Commission give the LECs greater general pricing flexibility or the ability to offer new services without previously filing sufficiently detailed cost support. The Commission should adopt a Report and Order in this proceeding which is consistent with the positions advocated herein.

Respectfully submitted,



AD HOC TELECOMMUNICATIONS
USERS COMMITTEE

Economic Consultants:

Dr. Lee L. Selwyn
Dr. David J. Roddy
Susan M. Gately
Scott C. Lundquist
Sonia N. Jorge
Economics and Technology, Inc.
One Washington Mall
Boston, Massachusetts 02018
(617) 227-0900

James S. Blaszak
Francis E. Fletcher, Jr.
Gardner, Carton & Douglas
1301 K Street, N.W.
Suite 900 - East Tower
Washington, D.C. 20005

Its Attorneys

May 9, 1994

**LEC PRICE CAP REGULATION:
FIXING THE PROBLEMS AND FULFILLING THE PROMISE**

**ANALYSIS OF ISSUES:
FCC PRICE CAP PERFORMANCE REVIEW FOR
LOCAL EXCHANGE CARRIERS**

CC Docket 94-1

Dr. Lee L. Selwyn
Dr. David J. Roddy
Susan M. Gately
Scott C. Lundquist
Sonia N. Jorge

prepared for the

Ad Hoc Telecommunications Committee

May, 1994

Table of Contents

Introduction and Summary	1
The Commission should not allow the Price Cap Plan to be manipulated into becoming a tool of industrial policy.	2
Efficiency gains enjoyed by firms in competitive industries are not permanent; the rewards for increased efficiency present in the LEC price cap plan should similarly apply only for a limited period of time.	2
The present “X Factor” of 3.3% is far too low and should be increased.	4
The scope and nature of exogenous cost adjustments should be further limited.	4
The access services market is not competitive today; there is no need for additional pricing flexibility in the LEC price cap plan at this time.	5
Other ongoing proceedings should not be affected by this review	6
General Issue 1: Goals of the LEC Price Cap Plan	7
General Issue 1: Should the Commission revise the goals of the LEC price cap plan so that the plan may better achieve the purposes of the Communications Act and the public interest, and if so what should be the revised goals?	7
<i>The bedrock “competitive result” objective of economic regulation is not — and should not be — modified or diminished under price cap or other forms of incentive regulation, and proposals for revision of the basic FCC price cap system should in all cases be evaluated with respect to their consistency with the fundamental “competitive result” goal.</i>	7

Table of Contents (Continued)

General Issue 2: Effect of Price Caps on Consumer Welfare	12
General Issue 2: What has been the effect of the price cap plan on consumer welfare, the economy, and the creation of jobs both in telecommunications and in other sectors of the economy. Quantify the effects of the price cap plan or of possible revisions on consumer welfare, the economy, and the creation of jobs in the future; <i>e.g.</i> , quantify the extent to which productivity is increased, the extent to which this increased productivity leads to domestic job growth, the extent to which profit margins improve because of the lower cost of telecommunications, and the ways in which the conduct of business has changed as a result of increasing reliance on telecommunications. We ask commenters to provide data and analysis on how the current price cap plan or a revised plan would affect growth in telecommunications markets, revenues, profits by LECs and CAPs, competition in local exchange and access services, competition in interexchange services, and levels of demand for telecommunications services.	12
<i>While some may attempt to attribute various events and conditions in the telecommunications industry and in the economy generally to price cap regulation, making such attributions at this time is extremely difficult.</i>	12
Baseline Issue 1: Infrastructure Development	29
Baseline Issue 1a: Whether, and if so how, the Commission should revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure.	29
Baseline Issue 1b: Whether the goal of providing universal service to all geographic areas and of equal type and quality for all Americans at affordable prices being met, or whether we should revise the LEC price cap plan to ensure the provision of universal service.	29
<i>The Price Cap form of regulation should not be used as a tool of industrial policy.</i>	29

Table of Contents (Continued)

Baseline Issue 2: Composition of Baskets and Bands	44
Baseline Issue 2: Whether the rules relating to the LEC price cap baskets and bands should be revised. Specifically, commenters should address whether current or revised price cap baskets and bands would reflect expected levels of competition for LEC interstate services, or other relevant common characteristics. For example, we request information and comment on whether differences in pricing behavior within and among baskets evidences different levels of competition.	44
<i>There is presently no need to change the rules relating to the LEC price cap baskets and bands.</i>	44
Baseline Issue 3: Changes in Productivity Factors or Rate Levels	47
Baseline Issue 3a: Whether the productivity factor used to compute the LEC price cap indices should be changed; in addition, or in the alternative, whether a one-time change in the LEC's price cap index should be required. If a rate reduction were required, commenters should discuss how such a reduction should be distributed among price cap baskets and service categories. As a further alternative, whether the Commission should adopt a mechanism which would adjust the plan to reflect changes in interest rates. Commenters should discuss how such a mechanism would operate, including, for example, what deviations in interest rates would trigger the adjustment mechanism. Commenters should address how the option they advocate would preserve or improve price cap incentives and assure just and reasonable rates.	47
Baseline Issue 3c: If the productivity factor should be changed, what method should the Commission use to determine a revised and reasonable productivity factor?	47
<i>The Commission must increase the X factor in the LEC price cap formula: Otherwise, the productivity gains achieved under the price cap system will not be flowed through to ratepayers, resulting in windfall gains in the LEC's earning.</i>	47

Table of Contents (Continued)

Baseline Issue 3b: Are the price cap LECs' profits levels reasonable under the current LEC price cap plan in light of the price cap goal that higher profits are intended to be the reward for attaining increased efficiencies?	66
<i>Price Cap LECs' profit levels have been excessive under price caps.</i>	66
Baseline Issue 4: Sharing and Low-end Adjustment Mechanisms	71
Baseline Issue 4a: Whether the sharing and low-end adjustment mechanisms should be realigned with capital costs, and if so, how this should be done.	71
Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.	71
<i>The sharing and low-end adjustment mechanisms should be retained, but the Commission must represcribe the benchmark rate of return to reflect the significant decline in capital costs since 1990.</i>	71
Baseline Issue 5: The Balanced 50/50 Formula	77
Baseline Issue 5a: Whether the Commission should reconsider its use of the Balanced 50/50 formula to cap common line charges.	77
Baseline Issue 5b: If so, what method should the Commission use to cap common line charges?	77
Baseline Issue 5c: If the Commission were to adopt a per-line charge, how should this affect possible changes in the productivity factor or the composition of baskets, e.g., changes such as the inclusion of common line rates in a public policy basket?	77

Table of Contents (Continued)

Baseline Issue 5d: What incentives are generated by the current Balanced 50/50 formula, the per line formula, or other possible formulas? What incentives should the formula seek to generate?	77
<i>The Commission should be cautious regarding any changes in its original well-thought-out and balanced compromise.</i>	77
Baseline Issue 6: Exogenous Cost Changes	78
Baseline Issue 6a: Whether the number of cost changes currently eligible for exogenous treatment under price caps should be reduced.	78
<i>The scope and nature of exogenous cost adjustments should be further limited.</i>	78
Baseline Issue 6b: If so, which cost changes should be eligible for exogenous treatment under price caps.	81
<i>A strict definition of allowable exogenous adjustments is an essential step in transitioning the LECs toward the exigencies of a more competitive marketplace.</i>	81
Baseline Issue 6c: Whether we should adopt an administrative process to allow access customers or other groups to request cost changes eligible for exogenous treatment and, if so, what should be the procedures in such an administrative process?	82
<i>The Commission's proposal to establish an administrative process that would permit access customers or other groups to request consideration of potential exogenous cost adjustments is appropriate.</i>	82

Table of Contents (Continued)

Baseline Issue 7: Service Quality, Infrastructure Monitoring and Network Reliability

Baseline Issue 7a: Whether the Commission should increase or revise monitoring of the LECs' network reliability, service quality and infrastructure development. Commentors are requested to submit data, information, and proposals in this inquiry that their view will contribute to assuring state-of-the art reliability, service quality, and infrastructure development for the LECs. Commentors are also requested to submit data identifying the administrative and business costs associated with their proposals. 84

Baseline Issue 7b: Whether and if so how the Commission should expand its service quality monitoring to include price cap LEC facilities and services that may be interconnected with the local exchange network or used to provide similar capabilities including wireless services and coaxial cable. Commentors are requested to submit specific data on the administrative and business costs associated with their recommendations on the reporting requirements. 84

The Commission must continue to closely monitor service quality and infrastructure development. 84

Baseline Issue 8: Rates and Regulations for New Services 86

Baseline Issue 8a: Whether the LEC price cap new services requirements impose unnecessary regulatory impediments to the development and introduction of new services with specific identification of what those impediments are and an assessment of their magnitude. 86

The new service requirements do not impose an unnecessary regulatory impediment to the development and introduction of new services. Rather, they protect monopoly ratepayers who have no alternative but the LEC for purchasing such new services. 86

Table of Contents (Continued)

Baseline Issue 8b: Whether and how we should modify the LEC price cap new services procedures and cost support rules to ensure that these rules advance our goals of encouraging innovation and setting reasonable rates.	87
<i>Granting price cap LECs additional pricing flexibility by modifying the new services procedures and cost support rules is not likely to significantly enhance the level of innovation the access service market.</i>	87
Baseline Issue 9: Equalization of Regulation for LECs and CAPs	89
Baseline Issue 9a: Whether our current rules for computing AT&T's exogenous access costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs.	89
<i>The Commission should not revise its rules to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous costs.</i>	89
Baseline Issue 9b: Whether any other rules or policies that relate to LEC price cap regulation should be revised to equalize our treatment of LECs and CAPS, and if so, what the revised rules and policies should be.	91
<i>There is no reason to equalize the treatment of LECs and CAPs under the Commission's current price cap rules.</i>	91
Baseline Issue 10: Sales and Swaps of Exchanges	93
Baseline Issue 10: Whether, and how, the process for granting waivers of the price cap rules governing mergers and acquisitions or the price cap rules themselves should be revised so as to prevent unreasonable cost shifting and maintain the efficiency incentives of the price cap plan.	93
<i>The Commission should not revise its waiver rules at this time.</i>	93

Table of Contents (Continued)

Baseline Issue 11: Other Revisions to the Current LEC Price Cap Plan	94
Baseline Issue 11: Whether the Commission should adopt revisions to the baseline LEC price cap plan in areas other than those specifically discussed in this notice.	94
<i>The Commission should modify the price cap rules as follows: “Add-back” of sharing revenues should be required; “add-back” of LFAs should not be allowed.</i>	94
Baseline Issue 12: Relationship to Other Proceedings	98
Baseline Issue 12: How the Commission should coordinate the LEC price cap review and any changes in the LEC price cap plan with other proceedings and proposals.	98
<i>The Commission should carefully coordinate LEC price cap review with its other on-going proceedings.</i>	98
Transition Issue 1: Criteria for Reduced or Streamlined Regulation of Price Cap LECs	99
Transition Issue 1a: What is the current state of competition for local exchange and interstate access?	99
Transition Issue 1b: What criteria if any should be used for determining when reduced or streamlined regulation for price cap LECs should take effect? For example, in determining whether a service is subject to sufficient competition to be moved from price cap regulation to reduced or more streamlined regulation, should the Commission take into consideration (1) the nature and extent of any barriers to market entry and exit (e.g., regulatory, economic, or technological obstacles), (2) the existence of potential and actual competitors and, if so, what role should the existence of potential and actual competition play in determining whether to reduce or streamline LEC price cap regulation, (3) the extent to which those competitors have the facilities to serve LEC customers, (4) the willingness of customers to use competitors’ services and, if so, how should this criterion be measured, (5) the competitors’ market share and, if so, how should the term “market” be defined, (6) pricing trends, (7) the effect of expanded interconnection, (8) differences in competition in different geographic locations	